> "Although many corporate executives concede that the new rule would slash reported earnings and reduce book values substantially, the FASB proposal so far has caused little stir on Wall Street. Most analysts seem to think that Congress will step in at the last minute, or that FASB will back down, or that the companies themselves will duck out on their promises before the rule goes into effect. Shrugs Lee Seidler, an accounting specialist with Bear Stearns, 'It will be a big yawn.'"[41]

Even today, the impact of SFAS 106 is not entirely clear according to the investment community. No less an authority than Standard & Poor's, as recently as June 15, 1992, suggested that implementation of SFAS 106 will not negatively impact utility ratings.[42]

The rate of return discussion by ETI demonstrates a lack of understanding of the FCC rate of return prescription process. ETI refers on several occasions to the impact of SFAS 106 on stock prices, but does nothing to explain how this impact would be translated into a different rate of return finding, assuming for the sake of argument that there was such an impact. Presumably, ETI is referring to the impact of stock prices on one of the components of the Discounted Cash Flow (DCF) methodology relied upon by the FCC in its rate of return prescription process. The DCF methodology basically provides that the equity return required by investors can be determined by adding the dividend yield and the expected growth in dividends. The dividend yield is measured by dividing the

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41 D. Henriques, "Double Whammy", Barron's, April 17, 1989, page 8.

42 Standard & Poor's Creditweek, "Utilities and FAS 106", June 15, 1992, Reprint page 1.

dividend by the price of the stock. If the dividend remains the same and the price increases, the dividend yield becomes lower. Conversely, if the price decreases (as ETI would have us believe occurred in this instance due to the negative reaction associated with the announcement of SFAS 106), the dividend yield becomes higher. What ETI ignores, however, is the impact that a negative reaction would have on the other component of the DCF formula, the growth in dividends.[43] Since the growth in dividends is paralleled by the growth in earnings, and the impact of SFAS 106 is presumed to reduce earnings, the growth factor in the DCF formula would decrease. The net result is that the return required by investors, as determined by the DCF formula, remains unchanged. In any case, the FCC has recognized that it is simplistic to assume that a change in stock prices will necessarily lead to a change in expected return.[44]

MCI relies on the Affidavit of Professor Drazen to support its contention that the cost of equity as calculated by the FCC has already captured the cost of SFAS 106. Professor Drazen, in turn, relies on a paper by Mittelstaedt and Warshawsky,[45] ("Warshawsky") that he characterizes -- incorrectly -- as suggesting that "given the high degree of

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43 The Affidavit of Professor Allan Drazen (p. 3) submitted by MCI improperly seeks to gloss over this point by referring to "a far less clear effect on estimates of G."

44 1990 Rate of Return Prescription Order, para. 133.

45 "The Impact of Liabilities For Retiree Health Benefits on Share Prices", supra.

uncertainty regarding the impact of SFAS 106 before it was adopted, there was a clear depressing effect on stock prices."[46] It is little wonder that Professor Drazen chose merely to reference -- and not to include -- the Mittelstaedt and Warshawsky paper in his Affidavit. The Abstract of the paper -- which was written a full four months after the introduction of SFAS 106 -- suggests an entirely different conclusion, namely that the impact on stock prices cannot be determined:

> "This study examines the association between liabilities for retiree health benefits and share prices. Results suggest that market estimates of the liabilities are imprecise. To the extent that the imprecision is due to insufficient accounting disclosures, significant price adjustments, upward and downward, may occur when information required by a new accounting standard is disclosed. Additionally, there is some evidence indicating that the market does not expect the health benefit obligation to be paid in full. This result is consistent with market expectations that the firms or the federal government will take actions to reduce future health benefit payouts." [Emphasis Added.][47]

MCI carries Professor Drazen's arguments one step further, stating:

> "To determine the LEC cost of equity, the Commission employed a DCF model, using data from the Regional Bell Operating Companies (RBOCs). RBOC stocks are among the most widely held stocks in the country, and consequently, the earnings of these companies are scrutinized and researched by the major brokerage

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46 Drazen Affidavit 5.

47 Mittelstaedt and Warshawsky, Abstract. See also Standard & Poor's Creditweek, September 11, 1989, as cited in Warshawsky, page 6: "The ability to quantify future medical liabilities of retirees will be difficult given the need to make assumptions which may or may not prove valid."

> houses. Therefore, it is reasonable to assume that key cost considerations would be carefully reviewed.... [T]he relatively generous provisions of RBOC OPEB plans would certainly be viewed as a portion of the total labor costs each of these firms was facing."[48]

The MCI pleading makes two key errors. First, it refers to only RBOC data being used by the Commission, and only for January - July 1990. In fact, the Commission used a record of both RBOC data and S&P 400 data over the entire period 1984-1990. The Commission stated: "We have accepted in principle the LEC suggestion that analysis of the costs of equity of the S&P 400 firms can provide a benchmark...."[49]

MCI's second error is in its assumption that "RBOC OPEB plans" would have been factored into RHC stock prices during the January - July 1990 period. As noted above, MCI presents no evidence that this was the case. In fact, the Drazen Affidavit does not even include data on the RHCs, but only refers to the Warshawsky study of approximately 200 industrial firms.

The risk associated by investors with the costs of SFAS 106 is considered to be a diversifiable risk. That is, there are sufficient differences among the SFAS 106 obligations of American companies, that investors who seek to avoid the risk they perceive to be attendant to SFAS 106 can do so merely

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48 MCI 12, 14.

49 <u>1990 Rate Of Return Prescription Order</u>, para. 179. In that <u>1990 Rate of Return Prescription Order</u>, the FCC also made an unspecified downward adjustment to RHC cost of equity for January - July 1990 to reflect a perception that nonregulated activities are riskier than interstate access. <u>Id</u>. at paras. 9, 188.

by purchasing shares in companies that have a lesser SFAS 106 exposure, or no exposure at all. It is precisely because this risk is diversifiable that portfolio theory maintains that investors do not require a higher rate of return to compensate for it.[50]

Moreover, the FCC has prescribed the interstate access rate of return to provide a fair return to shareholders after compensation for all just and reasonable operating expenses of the business.[51] The Commission has observed that:

> "rate of return, the percentage expression of financing expenses, is just as real an expense to AT&T as are wages and materials expenses.... A carrier must earn enough to cover all costs of operation and provide a return to investors."[52]

Inasmuch as recoverable expenses would include OPEBs (previously pay-as-you-go, now to be accrued under SFAS 106), the prescribed rate of return is simply not the mechanism designed to provide such expense recovery.

In sum, the allegation by Ad Hoc, ICA and MCI that the current FCC-prescribed interstate access rate of return included a recognition of SFAS 106 costs, is invalid and should be rejected.

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50 William F. Sharpe, Portfolio Theory and Capital Markets, McGraw-Hill, New York, 1970, page 97. See also Eugene F. Brigham Fundamentals of Financial Management, 5th edition, The Dryden Press, Chicago, 1989, page 122.

51 See LEC Price Cap Order, paras. 1, 22, 24.

52 AT&T, Petition For Modification of Prescribed Rate of Return, CC Docket No. 79-63, Decision released May 7, 1981, 86 FCC2d 221, para. 5.

IV. PARTIES' PROPOSED LIMITATIONS ON SFAS 106 EXOGENOUS COST RECOVERY ARE BASELESS

It should be emphasized that AT&T does not object in principle to exogenous treatment of SFAS 106 implementation costs (indeed, AT&T had sought such treatment for itself even before the accounting change was issued); rather AT&T recommends quantitative constraints on recovery. MCI recommends limitations in case exogenous treatment is approved. And, Ad Hoc and ICA seek to portray SFAS 106 costs as so difficult to quantify that no recovery should be granted. These parties' arguments are without foundation.[53]

A. Mandating Identical Assumptions For Price Cap LECs Would Be Inappropriate

Ad Hoc contends that the SFAS 106 obligation is not certain, i.e., it is dependent upon numerous assumptions that vary greatly among the price cap LECs. Ad Hoc's implication is that the FCC cannot effectively monitor these costs.[54] This assertion is similar to AT&T's argument (p. 25) that all LECs should be forced to utilize identical actuarial assumptions in calculating SFAS 106 costs for ratemaking purposes.[55] In

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53 The ETI Report (at 6), relied upon by Ad Hoc and ICA, essentially suggests that SFAS 106 costs are so "elusive" and complex that the FCC lacks the powers of discernment to quantify those costs. In effect, these parties would have the Commission throw up its hands in despair and disallow any exogenous recovery. This position must be rejected. Ample evidence has been submitted to enable the Commission in its expert judgment to reasonably determine SFAS 106 implementation costs.

54 ETI Report 5-6.

55 See also MCI 17.

fact, AT&T suggests (pp. 27-28) picking a set of the most aggressive assumptions (i.e., those which keep the SFAS 106 cost lowest) from the various Direct Cases. For example, according to AT&T, since BellSouth utilized 9.0% as its discount rate, all LECs should use 9.0%; since the highest assumed long term earning rate was 9.0%, all LECs should be forced to use 9.0%. AT&T suggests the same methodology for picking assumptions on medical inflation and for capping company contributions to health benefits.[56]

These suggestions must be rejected by the FCC. While ideally all companies should have similar actuarial assumptions, mandating exactly equal assumptions is not appropriate. SFAS 106 requires each company to value its liability using its best estimate for each assumption. The NYNEX Telephone Companies' assumption concerning medical trend rates, for example, could very well be different than the

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56 AT&T points to (p. 21) the NTCs' range of SFAS 106 cost estimates as evidence that the actuarial assumptions play a critical role in determining the exogenous factor, and concludes that a set of assumptions must be mandated. We submitted this range of estimates in good faith given that we have not yet filed our tariff. One assumption (relating to nonmanagement health care costs) does make a significant difference in the cost estimates, but we will submit a single estimate with our tariff filing reflecting SFAS 106 implementation. One must remember that SFAS 106 requires each company to make its best estimate of all actuarial assumptions in valuating the OPEB liability. Depending upon factors including the collective bargaining process, each company may have specific assumptions regarding company contributions to retiree benefits. MCI criticizes (p. 18) the level of detail that most price cap LECs provided in their cost estimates. However, we will provide all necessary detail in our tariff filing. That submission will be subjected to the traditional scrutiny given to price cap filings by both the FCC and interested parties.

appropriate rate for another price cap LEC, simply because of different inflation pressures among various geographic regions. The availability of medical services may also differ among regions, affecting both medical price growth and utilization patterns. Furthermore, the design of retiree benefit plans differs among regions and is significantly determined by the collective bargaining process. Finally, the initial medical trend rate for each company may differ; that rate should be consistent with the latest year's actual experience for that company. Thus, it is entirely reasonable for one company's medical trend rate to begin at 15% while another's initial rate is 10%.

One must remember that LECs entered price cap regulation with initial rates as they existed in July 1990 (when the NTCs followed pay-as-you-go accounting for OPEBs). The Commission should allow exogenous treatment for the incremental costs associated with accounting for OPEB benefits, i.e., the amount over the pay-as-you-go amounts currently reflected in the price cap index for each company.

Collective bargaining's major impact on OPEB plan design, as well as the OPEB percentage of total compensation, also require that each company develop its own capping of benefits assumption. A collective bargaining unit in one geographic region may be more willing to trade benefit coverage for other contract provisions than its counterpart in a different region.

The AT&T recommendation to prescribe a set of assumptions (each yielding the lowest estimate of SFAS 106 costs) for all LECs is totally arbitrary, especially since AT&T chooses individual assumptions from various companies solely for the purpose of minimizing the SFAS 106 accrual for ratemaking purposes. AT&T knows very well that each assumption made by an individual company is not totally independent of the other assumptions made in the SFAS 106 valuation. For example, inflation pressures (both general economic inflation and medical inflation) and collective bargaining factors affect each company's views on medical trend rates, benefits plan changes and the potential for sharing medical cost growth between the company and retirees. Also, a forecast of relatively low general inflation (both economy-wide and in the medical sector) would not be consistent with choosing a high discount rate. Additionally, the nature of each individual company's OPEB liability could impact its investment strategy for prefunding OPEB benefits; thus differences among assumed long term earnings rates for individual companies are readily justified.

All of these factors overwhelmingly point to the need for each LEC to establish its own actuarial assumptions in order to provide a best estimate for SFAS 106 costs. Paragraph 185 of SFAS No. 106 states that:

> "no standard plan design or package of postretirement benefits or a static set of circumstances exists that would call for all employers to use the same assumptions. Different types of benefits may have differing trend rate assumptions, and different employers may have differing expectations about benefit utilization. Because of differences in plan design and employer circumstances, including the expected demographics of the plan population, measurement assumptions about the timing and amount of future benefits should represent an employer's best

> estimate with respect to the factors affecting its particular promise."

The FASB's conclusion recognizes that requiring all employers to use the same assumptions would be inappropriate in that it could compromise the quality of information.[57]

Finally, the opposition filings have severely overstated the degree of variation that presently exists among the price cap LECs' actuarial assumptions. All but three of the price cap LECs utilized a discount rate of 8.0% or 8.5%; virtually all of the LECs provide for some sharing mechanism of future medical costs between the company and retirees; the earnings rate assumptions average 8.0%; and the medical trend rates slope down from current experience to an average of 6.0% within about 13 years.

In sum, our opponents' recommended constraints relative to OPEB exogenous cost recovery should be dismissed.[58]

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57 AT&T also presents (Appendix F) a "sensitivity analysis" of the Pacific Bell actuarial valuation. Again, AT&T's recommendation to mandate uniform assumptions is unacceptable and violates the SFAS 106 requirement for each company to make its best estimate of OPEB costs. Since there are numerous justifications for individual companies to have different actuarial assumptions (different inflation rates by geographic region, different benefit plans, different collective bargaining agreements, different investment strategies, etc.) the sensitivity analysis using mandated assumptions is totally irrelevant. AT&T has failed to recognize that all actuarial assumptions are interrelated, and that it is actuarially unacceptable to systematically choose assumptions with the sole aim of minimizing the SFAS 106 accrual.

58 In any event, this case purely concerns to what extent the Commission will provide for SFAS 106 implementation costs

(Footnote Continued On Next Page)

B. The Commission Should Reject AT&T's Argument That Only Prefunded OPEB Costs Should Be Considered For Exogenous Treatment

AT&T inappropriately contends that (pp. 14-15) only prefunded OPEB costs should be afforded exogenous recovery. The issue of whether or not a price cap LEC chooses to prefund its OPEB liability is totally irrelevant to the matter at hand -- i.e., that the new requirement to accrue for postretirement benefits costs represents an exogenous cost change to LECs under price cap regulation. The Commission should grant exogenous treatment for the incremental expense associated with SFAS 106 and then treat this portion of total expense as it does all other company expenses, i.e. with no conditions set forth for the use of funds. As a parallel to OPEB expenses, SFAS 87 pension cost accruals are included in current rates, but there is no FCC requirement to use this portion of rates only to prefund pension benefits. In fact, LECs may be

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58 (Footnote Continued From Previous Page)

to be reflected in computing the "Z" adjustment in the price cap formula. Several opponents' arguments over the assumptions used by price cap LECs go beyond this issue and address the validity of the SFAS 106 costs themselves. The latter subject is not at issue in this case, nor should it be under price cap regulation. Should the FCC ultimately determine, solely for the purpose of calculating a one-time exogenous cost adjustment, that some commonality in assumptions among price cap LECs may be warranted, the NTCs would of course be willing to work with the FCC Staff and the industry. It should be emphasized that any such commonality of assumptions would only be for the purpose of determining the exogenous adjustment, and not the SFAS 106 costs recorded on our books. AT&T appropriately recognizes this distinction (pp. iii, 5 n. 1).

precluded (by IRS full funding limitations) from making further pension fund contributions.

It is also noteworthy that to the extent a price cap LEC does not fund OPEB expense accruals, the rate base will be reduced,[59] to the benefit of ratepayers to the extent the sharing and low end adjustment mechanisms would apply.

C. MCI'S RECOMMENDATIONS FOR MONITORING AND TRUE-UPS OF OPEB COSTS SHOULD NOT BE ADOPTED

MCI suggests that (n. 14) true-up filings may be required in the event the Commission finds that OPEB costs should be afforded exogenous treatment. MCI argues that tracking and review of the changes in the accruals, as well as the total asset values of the plans, are required to verify that rates based on the changes are just and reasonable. MCI proposes that special reporting structures be developed through revised Tariff Review Plan (TRP) and ARMIS reports to track these changes.

There is no need to change the basic structure of TRP and ARMIS reports in order to review OPEB adjustments, even in the event annual "true-up" filings are required. The existing TRP format has been determined to provide sufficient detail on other exogenous cost adjustments for the 1991 and 1992 annual access tariff filings, and OPEB exogenous adjustments may be readily included. Additional support on OPEB adjustments could

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59 47 C.F.R. 65.830(a)(3); RAO Letter 20 released May 4, 1992 Re: Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32.

always be provided in the filing's Description and Justification, just as it is for other exogenous changes. Similarly, ARMIS reports should not be revised to provide additional levels of reporting requirements. In Price Cap Orders, the Commission has repeatedly acknowledged the adequacy of existing ARMIS reporting requirements for monitoring purposes under price cap regulation,[60] and has rejected requests for further disaggregation. Additional requests to expand ARMIS or change the purpose of the reports should be rejected.

The incremental expense associated with accounting for postretirement benefits under SFAS 106 should be treated as a one-time adjustment to the price cap index, since we are merely asking to include a newly mandated portion of expense that was not included in initial price cap rates. In theory, once exogenous treatment is granted, OPEB accruals should be treated like other company expenses, i.e., subject to the GNP-PI minus productivity adjustment formula. The NYNEX Telephone Companies do agree, however, that certain unforeseen future events (e.g., institution of a national health insurance program) could substantially change SFAS 106 accruals. Such a major deviation between SFAS 106 assumptions and actual experience could warrant an additional exogenous factor and/or a true-up of the incremental amount allowed in rates.

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60 LEC Price Cap Order, para. 373; LEC Price Cap Reconsideration Order, para. 200.

V. CONCLUSION

Nothwithstanding the opposition filings, the Commission should approve exogenous recovery of incremental costs arising from SFAS 106 accrual accounting for nonpension postretirement benefit expenses.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that copies of the foregoing REPLY COMMENTS OF THE NYNEX TELEPHONE COMPANIES were served on each of the persons listed on the attached Service List, this 31st day of July, 1992, by first class United States mail, postage prepaid.

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UNITED STATES TELEPHONE ASSOCIATION

Analysis of Impact of SFAS 106 Costs on GNP-PI

Supplemental Report:
Responses to Objections Raised Regarding Original Study

Godwins

July, 1992

INTRODUCTION

Earlier this year, Godwins submitted a report to the United States Telephone Association (USTA) analyzing the impact of SFAS 106 on the GNP-PI, and, in particular, the extent to which the GNP-PI will reflect the increase in costs experienced by the Price Cap LECs as a result of adopting the new accounting standard. This report was placed on the record with the FCC in Bell Atlantic's Tariff Transmittal filed on February 28, 1992 (Transmittal No. 497) and was also included in U.S.West's Tariff Transmittal filed on April 3, 1992 (Transmittal No. 246).

In their filings with the FCC, several organizations took exception to the findings of that report. In particular, AT&T, MCI and the Ad Hoc Telecommunications Users Committee raised several objections with regard to various aspects of the study. The USTA has asked Godwins to provide a detailed response to each of those objections.

The purpose of this Supplemental Report is to provide the USTA with those responses. We have organized our responses into three sections, corresponding to the three different types of objections raised.

While the objections raised were numerous, this material will demonstrate that none of the objections raised should cause the Commission to have any doubts regarding the soundness of the study, or the validity of the results.

Respectfully Submitted,

Peter J. Neuwirth, F.S.A., M.A.A.A.

Andrew B. Abel, Ph.D.

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SECTION I

RESPONSE TO OBJECTIONS REGARDING OVERALL STUDY

A. Definition of Double Count

There were two objections raised with respect to the manner in which we defined the potential sources of double counting and what sort of analysis would be required to eliminate any double counting in determining the portion of the LECs' SFAS 106 costs that should qualify for exogenous treatment.

AT&T Contention - (Pages 6 and 7) "The LEC's have failed to demonstrate that the Commission's third criteria is met. To the contrary, the LECs' requests for exogenous treatment appear to reflect certain OPEB costs that will be reflected in the GNP-PI ... The double count occurs because (i) the GNP-PI component of the PCI will increase as all firms with OPEB liabilities reflect those costs through higher prices, and (ii) the SFAS 106 accrual calculation includes the present value of future inflation. If the SFAS 106 accrual is afforded exogenous treatment, the amount of the accrual will be increased automatically in future periods due to growth in inflation expressed by the GNP-PI component of PCI.** Therefore, if inflation is included in both the exogenous cost component and GNP-PI, an LEC would be compensated twice. Although the LECs recognize this problem, no carrier has met its burden of showing that it has effectively removed this double count."

Response - AT&T's description of what it considers the source of potential double counting in the LECs' request for exogenous treatment for increased costs due to SFAS 106 demonstrates some confusion as to both the double count problem and the Godwins Report. Essentially AT&T suggests that double counting may arise from two separate sources:

(1) Increases in the PCI due to increases in the GNP-PI caused by "firms with OPEB liabilities reflect(ing) those costs through higher prices."

(2) Automatic increases in the exogenously treated portion of SFAS 106 accrual "due to growth in inflation expressed by the GNP-PI component of PCI."

The first source of potential double count, while a valid concern, is <u>precisely</u> the factor that the Godwins Report directly and thoroughly addresses. The first paragraph of page 1 of the Godwins Report explicitly states this as the primary objective of the study. As will be seen in the responses to specific criticisms of the Godwins Report, no respondent has raised any issue which, upon scrutiny, casts doubt on any of the basic findings of the study. Therefore, the Commission should accept the Report's conclusions that (a) this source of double count accounts for 0.7% of the increase in costs attributable to SFAS 106, (b) another 14.5% of the increase will be recovered through a reduction in the national wage rate, and (c) the remaining 84.8% of such increase in costs will remain unrecovered unless exogenous treatment is granted on this amount.

The second alleged source of double counting simply doesn't exist, and is the result of confusion over exactly what the LECs are requesting. While it is true that the SFAS 106 expense calculation includes the present value of future inflation, and that the expense calculated under SFAS 106 can be expected to increase each year at something close to the rate of inflation, <u>SFAS 106 expense is not what the LECs are requesting exogenous treatment on</u>. It is the <u>increase</u> in expense due to the SFAS 106 <u>accounting change</u> that should be afforded exogenous treatment. This is an absolutely critical distinction which is missed by AT&T. Retiree medical plans were sponsored by firms before and after SFAS 106 was issued. It is only the accounting for those plans that has changed, and it is the increase in costs associated with this change in accounting that must be evaluated.

MCI Contention - (Page 30)

"If one were to include SFAS 106 costs through exogenous treatment, the revenues resulting from the increase in the price cap index to account for these costs would also increase each year by the GNP-PI, as adjusted for the productivity factor. The problem is that SFAS 106 costs have already been adjusted for future inflation...Therefore, the impact of medical care cost inflation has already been counted. As such the amount offered by the LEC's has been inflated to reflect future medical costs. To include these costs again within the price cap formula through exogenous treatment, and treat them by the full amount of GNP-PI which has medical inflation embedded as well is tantamount to double counting the medical care inflation rate."

Response -

This contention is virtually identical to the second "source" of double counting outlined by AT&T on page 7 of its filing with the Commission. Rather than repeat our response to that contention, we would just point out that, like AT&T, MCI seems to have failed to grasp the point that the LECs are not asking for exogenous treatment on the SFAS 106 expense, rather they are asking for exogenous treatment on that portion of the increase in expense due to the mandated accounting change, which will not already be reflected in GNP-PI increases caused by that accounting change.

B. Avoidance of Double Count

Two respondents suggested "better" ways of determining the extent of the double count problem, and therefore "better" ways of determining the appropriate portion of SFAS 106 costs that should qualify for exogenous treatment.

AT&T Contention - (pp. 13 - 14)

"....The Commission should require the LEC's to use an alternative that is both a simpler and more reliable means for correcting the double count. AT&T suggests that the appropriate method for removing the double count between the SFAS 106 accrual and the GNP-PI term in the price cap formula is to remove the impact of expected changes in GNP-PI from the SFAS 106 accrual. This can be accomplished in a straightforward manner by requiring the LEC's to subtract the expected rate of change of GNP-PI from the health care inflation component in the SFAS 106 accrual. The Commission should specify the changes in GNP-PI over the SFAS 106 forecast period. Current estimates is (sic) that GNP-PI will increase approximately 4% over the long term."

Response -

That AT&T should suggest such an illogical and erroneous "solution" to the double count problem is indicative of a failure to understand the true source of any potential double counting. As discussed earlier, potential double counting is not related to the fact that SFAS 106 costs are calculated by discounting future medical inflation back to the present. As discussed on page 2 of this material, double counting will only arise to the extent that the increased costs companies will bear, as a result of the change in accounting method required by SFAS 106, will also cause an increase in GNP-PI.

The fact that the AT&T "solution" does not address the true source of potential double counting is illustrated in the following example, where the AT&T solution is shown to produce an identical exogenous adjustment in two factually different circumstances, where logic would dictate different exogenous adjustments be applied.

In the second footnote on page 13 of its filing, AT&T estimates that its "solution" of allowing exogenous treatment for SFAS 106 accruals, calculated using a medical trend rate 4% lower than the actual rate used by the LECs for their financial statements, might result in approximately 55% of a given LEC's actual SFAS 106 accrual being afforded exogenous treatment. Now let us consider two hypothetical scenarios:

(1) Every U.S. firm, LECs and non-LECs alike, have identical demographic makeups and provide identical retiree medical benefits. Thus, in this case, presumably every U.S. firm would experience the same increase in labor costs due to SFAS 106. In addition, under this scenario, it is assumed that all labor cost increases associated with SFAS 106 are completely reflected in the GNP-PI, as companies raise their prices to recover those costs.

(2) The LECs are the <u>only</u> firms subject to SFAS 106, and/or the additional costs due to the adoption of SFAS 106 costs are never reflected in the GNP-PI.

In the first scenario, it is obvious that the increased labor costs due to SFAS 106 experienced by the LECs would be fully and completely reflected in the GNP-PI (the Godwins Report, of course, demonstrates that this hypothetical situation does not exist), and thus no exogenous adjustment would be required. In fact, in this hypothetical scenario, providing any exogenous adjustment would result in a complete double count. Yet in this circumstance, the AT&T approach of allowing recovery of SFAS 106 costs, calculated using a lower trend rate (medical inflation minus 4%), would, as noted above, result in allowing exogenous treatment on 55% of SFAS 106 accruals.